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NOT TO BE PUBLISHED

IN THE COURT OF APPEAL OF THE STATE OF CALIFORNIA

THIRD APPELLATE DISTRICT

(San Joaquin)

ROBERT BERTLOW et al., Plaintiffs and Respondents, v. ARNAIZ DEVELOPMENT COMPANY, INC., et al., Defendants and Appellants.	C058523 (Super. Ct. No. CV031892)

In this residential construction defect case, defendants Arnaiz Development Company, Inc., and H.D. Arnaiz Corporation (collectively, Arnaiz) appeal from an order denying their motion to compel arbitration. (Code Civ. Proc., § 1294, subd. (a).)

We agree with the trial court that the arbitration agreement is unconscionable, and shall affirm the denial. In doing so, we rely on two recent decisions from the Court of Appeal, Fourth Appellate District, Division Two, *Baker v. Osborne Development Corp.* (2008) 159 Cal.App.4th 884 (*Baker*) and *Bruni v. Didion* (2008) 160 Cal.App.4th 1272 (*Bruni*), that found nearly identical arbitration agreements unconscionable.

PROCEDURAL BACKGROUND

Eighty plaintiffs owning 51 homes in Stockton have sued Arnaiz in court. Their complaint alleges construction defect based causes of action for breach of contract, breach of implied and express warranties, negligence, and strict products liability.

Arnaiz moved to compel arbitration for 17 of these plaintiffs (owners of 11 of the homes). Each of these plaintiffs (hereinafter, Plaintiffs) purchased a home from Arnaiz between January 2001 and February 2002. During this purchase process, Plaintiffs initially signed a "Purchase Agreement" from Arnaiz. Subsequently, just days before their escrows closed, Plaintiffs, at Arnaiz's direction, also signed a warranty application form, termed "Builder Application for Home Enrollment" (hereafter Builder Application), so that Arnaiz could enroll them for a warranty from the Home Buyers Warranty Corporation (HBW Warranty). Plaintiffs received this warranty after their escrows closed.

The Purchase Agreement and the HBW Warranty contain differing arbitration agreements.

Arnaiz moved to compel arbitration based solely on the HBW Warranty arbitration agreement. Arnaiz expressly disclaimed any attempt to enforce the arbitration provisions set forth in the Purchase Agreement.

The trial court denied Arnaiz's motion to compel arbitration. The court found, among other things, that the HBW

Warranty arbitration agreement--which invokes federal arbitration law (the Federal Arbitration Act [hereafter the FAA]; 9 U.S.C. § 1 et seq.)--"is unenforceable [because it] is procedurally and substantively unconscionable in that Plaintiffs had no meaningful opportunity to negotiate this term because it was hidden in the [HBW Warranty]. Plaintiff[s] had previously agreed to California law to govern arbitrations at the time they [signed their Purchase Agreements]. It is unconscionable to then change the choice of law around the time of the close of escrow, when it was, as a practical matter, too late to cancel the purchase."

In this appeal, Arnaiz raises a litany of contentions that boil down to: The evidence is insufficient to support the trial court's findings of unconscionability, and the FAA preempts California law and governs arbitration of contracts involving interstate commerce such as those here.

We will set forth the pertinent facts in the Discussion that follows.

DISCUSSION

I. General Principles Governing Arbitration Agreement Enforceability, Standard of Review, and Unconscionability

"[T]he strong policy in favor of [implementing] arbitration agreements does not arise until an enforceable agreement is established. [Citation.] In determining the enforceability of an arbitration agreement, generally applicable contract defenses, such as fraud, duress, and unconscionability apply.

[Citation.] Thus, . . . California law governs whether an arbitration agreement has been formed in the first instance, and whether an arbitration agreement exists is an issue for judicial determination." (*Baker*, *supra*, 159 Cal.App.4th at pp. 892-893.)

In reviewing on appeal a finding that an arbitration agreement is unconscionable, we consider the evidence in the light most favorable to the trial court's ruling and review the trial court's factual determinations under the substantial evidence standard, but we determine independently as an issue of law whether the supported facts meet the legal standard of unconscionability. (*Baker*, *supra*, 159 Cal.App.4th at p. 892; *Bruni*, *supra*, 160 Cal.App.4th at pp. 1282-1283.)

"'Unconscionability has both a procedural and a substantive element [we will set forth the definitions of these elements later in this opinion]. Both elements must be present for a court to invalidate a contract or clause, although the degree to which each must exist may vary.'" (*Bruni*, *supra*, 160 Cal.App.4th at p. 1288, quoting *Aron v. U-Haul Co. of California* (2006) 143 Cal.App.4th 796, 808 (Aron).)

With these principles in mind, we turn first to the issue of procedural unconscionability and then set our sights on its substantive sibling.

II. Procedural Unconscionability

A. Background

Evidence presented during the motion to compel arbitration, and reasonable inferences therefrom, show that when Plaintiffs

initially purchased their homes, they signed a standardized Purchase Agreement. This agreement contains the following pertinent provisions, including an arbitration agreement, which the purchasers initialed:

"**11.** . . .

"[¶] . . . [¶]

"**B. ARBITRATION OF DISPUTES:** Buyer and seller agree that any dispute or claim in Law or equity arising between them out of this Agreement or any resulting transaction, which is not settled through mediation, shall be decided by neutral, binding arbitration . . . . The arbitrator shall be a retired judge or justice, or an attorney with at least 5 years of residential real estate law experience, unless the parties mutually agree to a different arbitrator, who shall render an award in accordance with substantive California Law. In all other respects, the arbitration shall be conducted in accordance with Part III, title 9 of the California Code of Civil Procedure [titled "Arbitration"; Code Civ. Proc., § 1280 et seq.] . . . The parties shall have the right to discovery in accordance with Code of Civil Procedure, section 1283.05.

"'NOTICE: BY INITIALING IN THE SPACE BELOW YOU ARE AGREEING TO HAVE ANY DISPUTE ARISING OUT OF THE MATTERS INCLUDED IN THE "ARBITRATION OF DISPUTES" PROVISION DECIDED BY NEUTRAL [BINDING] ARBITRATION AS PROVIDED BY CALIFORNIA LAW AND YOU ARE GIVING UP ANY RIGHTS YOU MIGHT POSSESS TO HAVE THE DISPUTE LITIGATED IN A COURT OR JURY TRIAL. . . .'

"'WE HAVE READ AND UNDERSTAND THE FOREGOING AND AGREE TO SUBMIT DISPUTES ARISING OUT OF THE MATTERS INCLUDED IN THE "ARBITRATION OF DISPUTES" PROVISION TO NEUTRAL ARBITRATION.'

"Buyer's Initials ___ /___ Seller's Initials ___/___

"**C. EXCLUSIONS FROM MEDIATION AND ARBITRATION:** The following matters are excluded from Mediation and Arbitration: . . . (e) An action for . . . latent or patent [construction] defects to which Code of Civil Procedure[] section 337.1 [patent] or section 337.15 [latent] applies.[1] . . .

"[¶] . . . [¶]

"**14.** Seller to provide buyer, at sellers [*sic*] expense, a 2-10 Homebuyers Warranty [this is the HBW Warranty here].

"**15.** The Seller and its general contractor shall not be liable for any claims relating to the construction of the residence except under the terms and conditions of the written

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1 This exclusion provision, which is dictated from Code of Civil Procedure section 1298.7, swallows a real estate purchase agreement's arbitration provision in the construction defect context. (See *Villa Milano Homeowners Assn. v. Il Davorge* (2000) 84 Cal.App.4th 819, 830.) However, subsequent to Plaintiffs' home purchases here, section 1298.7 was rendered largely irrelevant in the real estate subdivision purchase context by two decisions, including one from this court, holding that the section is preempted by the FAA in real estate purchase transactions involving or substantially affecting interstate commerce. (*Basura v. U.S. Home Corp.* (2002) 98 Cal.App.4th 1205, 1208; *Shepard v. Edward Mackay Enterprises, Inc.* (2007) 148 Cal.App.4th 1092, 1094-1095, 1097, 1101; see also *Hedges v. Carrigan* (2004) 117 Cal.App.4th 578, 583 [the FAA preempts § 1298.7's related provision, § 1298].)

warranty to be given Buyer at closing. Seller makes no other warranties, whether expressed or implied, including the implied warranty of merchantability, and all such warranties are hereby waived by Buyer."

Just a few days before their escrows closed, Plaintiffs, at Arnaiz's direction, signed the one-page, standard Builder Application form. This form was an application to have an HBW Warranty applied to each of Plaintiffs' homes. This document ended with:

"**HOME BUYERS ACKNOWLEDGEMENT AND CONSENT**

"Your Builder is applying to enroll your home in the HBW insured warranty program. By signing below, you acknowledge that you have viewed and received a video of 'Warranty Teamwork: You, Your Builder & HBW', you have read the Builder's Copy of the Warranty Booklet, and CONSENT TO THE TERMS OF THESE DOCUMENTS INCLUDING THE BINDING ARBITRATION PROVISION contained therein. You further understand that when the warranty is issued on your new home, it is an Express Limited Warranty and that all claims and liabilities are limited to and by the terms and conditions of the Express Limited Warranty as stated in the HBW Warranty Booklet. . . .

"Homebuyer [signature line]."

Evidence also showed that Plaintiffs did not receive their HBW Warranty Booklet (hereafter, Warranty Booklet), version "1/1/01 HBW 307," until after their escrows closed.

The Warranty Booklet is a 28-page wonder of small print, featuring the following pertinent provisions buried within:

"SECTION VII CONDITIONS

"THIS IS AN EXPRESS LIMITED WARRANTY[.] All other express or implied warranties, including any oral or written statements or representations made by your Builder or any other person, and any implied warranty of habitability, merchantability or fitness, are hereby disclaimed by your builder and are hereby waived by you. In addition, you are waiving the right to seek damages or other legal or equitable remedies from your Builder, his subcontractors, agents, vendors, suppliers, design professionals and materialmen, under any other common law or statutory theory of liability, including but not limited to negligence and strict liability. Your only remedy in the event of a defect in or to your Home or in or to the real property on which your Home is situated is the coverage provided to you under this express limited warranty.

"[¶] . . . [¶]

"ARBITRATION[.] Any and all claims, disputes and controversies by or between the Homeowner, the Builder, the Warranty Insurer and/or HBW, or any combination of the foregoing, arising from or related to this Warranty, to the subject Home, to any defect in or to the subject Home or the real property on which the subject Home is situated, or the sale of the subject Home by the Builder, . . . shall be submitted to arbitration by and pursuant to the rules of Construction

Arbitration Services, Inc., . . . or by such other arbitration service as HBW shall, in its sole discretion select . . . .

"This arbitration agreement shall inure to the benefit of, and be enforceable by, the Builder's subcontractors, agents, vendors, suppliers, design professionals, insurers and any other person whom the homeowner contends is responsible for any defect in or to the subject Home or the real property on which the subject Home is situated. . . .

" . . . The decision of the arbitrator shall be final and binding . . . .

"[¶] . . . [¶]

" . . . No arbitration proceeding shall involve more than one single-family detached dwelling . . . .

"The parties expressly agree that this Warranty and this arbitration agreement involve and concern interstate commerce and are governed by [the FAA] . . . to the exclusion of any different or inconsistent state or local law, ordinance or judicial rule . . . ."

B. Analysis

"'The procedural element of unconscionability focuses on two factors: oppression and surprise. [Citation.] "'Oppression' arises from an inequality of bargaining power which results in no real negotiation and 'an absence of meaningful choice.'" [Citation.] "'Surprise' involves the extent to which the supposedly agreed-upon terms of the bargain

are hidden in a prolix printed form drafted by the party seeking to enforce the disputed terms." [Citation.]

"[¶] . . . [¶]

"'"The procedural element of an unconscionable contract [often] takes the form of a contract of adhesion [i.e., a standardized contract drafted by the stronger party on a take-it-or-leave-it basis to the weaker party] . . . ."'" (*Bruni*, *supra*, 160 Cal.App.4th at pp. 1288-1289, quoting *Aron*, *supra*, 143 Cal.App.4th at p. 808, and *Discover Bank v. Superior Court* (2005) 36 Cal.4th 148, 160.)

The cascade of documents quoted above effectively speaks for itself on procedural unconscionability. In light of that cascade, we can uphold--as easily as did the court in *Baker* in reviewing a substantively identical HBW Warranty arbitration agreement and process--the trial court's finding of procedural unconscionability and the conclusion that this agreement meets the legal standard of such unconscionability. (*Baker*, *supra*, 159 Cal.App.4th at pp. 888-889, 894-896.)

Paralleling a list of procedural unconscionability factors enumerated in *Baker*, here too (1) the HBW Warranty arbitration agreement was not included in the Purchase Agreement, but instead merely referred to in a misleadingly entitled Builder Application for the warranty; (2) to the extent the Builder Application was intended to be an agreement between the builder and homebuyer, its title was misleading; (3) Plaintiffs were not presented with their Builder Applications until just a few days

before their scheduled escrow closings; (4) the terms of the HBW Warranty arbitration agreement were not set forth in the Builder Application, but were buried in a 28-page, small-print Warranty Booklet sent to Plaintiffs after the close of escrow; (5) a reasonable buyer would assume that the HBW Warranty arbitration agreement governed disputes with HBW over warranty coverage, not disputes with the builder (and everyone else) over any construction defects; and (6) the HBW Warranty arbitration agreement apparently was an adhesive contract. (*Baker*, *supra*, 159 Cal.App.4th at pp. 894-895.)

Arnaiz, however, sees two significant distinctions between the present case and *Baker*. We do not.

First, Arnaiz points to sections 14 and 15 of the Purchase Agreement. As quoted above, section 14 states that seller is to provide buyer, at seller's expense, with an HBW Warranty. Section 15 adds that seller and its general contractor will "not be liable for any claims relating to the construction of the residence except under the terms and conditions of the written warranty to be given Buyer at closing." The problem for Arnaiz, though, is that these two small-print sections are phrased in a way of providing the protection of a warranty; they do not say anything explicit about undercutting the large-print arbitration agreement in the Purchase Agreement, an arbitration agreement initialed by Plaintiffs and much more buyer-friendly than the arbitration agreement found in the merely referenced HBW Warranty.

Second, Arnaiz notes that the Builder Application form signed by Plaintiffs states that Plaintiffs had "read the Builder's Copy of the Warranty Booklet, and CONSENT[ED] TO THE TERMS OF THESE DOCUMENTS INCLUDING THE BINDING ARBITRATION PROVISION contained therein." By contrast, in *Baker*, the buyers apparently submitted declarations stating that the Warranty Booklet was not presented to them before or when they signed the Builder Application. (*Baker, supra,* 159 Cal.App.4th at p. 895, see also *id.* at pp. 889-890.)

There are three problems in this regard. One, there was no evidence here that the Builder's Copy of the Warranty Booklet was actually provided for Plaintiffs' perusal before or when they signed the Builder Application. Two, Plaintiffs were given (after the close of escrow) the "1/1/01 HBW 307" version of the Warranty Booklet rather than the so-called "Builder's Copy" version. And, three, bare recitals in an adhesion instrument, such as the Builder Application, do not bar an assertion of unconscionability.

In *Bruni*, the home builder argued--like Arnaiz does here--that under Evidence Code section 622, the home buyers were bound by the recital in the one-page builder application there that they had "'read a sample copy of the warranty booklet.'" (*Bruni*, *supra*, 160 Cal.App.4th at p. 1291.) Section 622 provides: "The facts recited in a written instrument are conclusively presumed to be true as between the parties thereto . . . ." However, after noting that section 622 does not bar an

assertion of fraud or other grounds for rescission because this would be impermissible bootstrapping, *Bruni* concluded: "For similar reasons, [section 622] should not apply to recitals in an adhesion contract." (*Bruni*, at p. 1291.)

Arnaiz also levels two general broadsides. Again, we are unmoved.

In the first broadside, Arnaiz claims the evidence is insufficient to show procedural unconscionability because there was no evidence presented that Plaintiffs actually signed the Purchase Agreement and initialed the arbitration agreement contained therein. For their evidence, Plaintiffs relied on the following documents: the Purchase Agreement signed by the lead plaintiff, Robert Bertlow (who is not part of this appeal), and the arbitration agreement therein initialed by him; the Builder Applications signed by Plaintiffs; and the HBW Warranty certificate and the Warranty Booklet sent to Plaintiffs. Although Plaintiffs presented only lead-plaintiff Bertlow's Purchase Agreement in evidence, the Builder Application and other warranty-related documents would not exist without corresponding purchase agreements. To apply for and obtain an HBW Warranty, one has to be purchasing a home. All of the documents presented display adhesion contracts. In its opening brief on appeal, Arnaiz concedes that "[w]hen purchasing their homes, Respondents [i.e., Plaintiffs] signed a form Purchase Agreement." Consequently, it reasonably may be inferred that Plaintiffs signed the Purchase Agreement and initialed its

arbitration agreement, as did plaintiff Bertlow; and the trial court properly drew this inference (stating, "No evidence suggests [that Bertlow's Purchase Agreement] was not used for each sale to plaintiffs in this case").

As for the second broadside, Arnaiz casts Plaintiffs as ungrateful for the warranty benefits bestowed upon them. Arnaiz argues that nothing could be more unjust than to permit a homebuyer to obtain a free warranty at substantial cost to his builder, retain the benefits of that warranty, and yet avoid the arbitration agreement in the warranty. After all, Arnaiz notes, it paid around $350 per home to obtain the HBW Warranty on behalf of Plaintiffs. For this princely sum, though, Arnaiz sought to foreclose Plaintiffs from suing Arnaiz in court for any construction defects, while limiting its liability and that of any other responsible party to only a quite limited, Limited Warranty. (See "SECTION VII," "EXPRESS LIMITED WARRANTY" (quoted above from HBW Warranty Booklet) at pp. 8-9, *ante*; see also *Bruni, supra,* 160 Cal.App.4th at p. 1276 [describing the meager nature of the HBW Warranty].)

For reasons explained above, and supplemented by those set forth below in the next section of this opinion, we do not share Arnaiz's view of Plaintiffs' ingratitude. Furthermore, the legal principle upon which Arnaiz relies here--Civil Code section 1589--states that "[a] voluntary acceptance of the benefit of a transaction is equivalent to a consent to all the obligations arising from it, *so far as the facts are known, or*

ought to be known, to the person accepting." (Italics added.) Here, the substantial evidence of procedural unconscionability shows that the arbitration agreement facts were not known, or reasonably capable of being known, by Plaintiffs.

We now turn to substantive unconscionability.

III. Substantive Unconscionability

"'The substantive element of unconscionability focuses on the actual terms of the agreement and evaluates whether they create "'overly harsh'" or "'one-sided'" results as to "'shock the conscience,'"' that is, that are not within the "reasonable expectations" of the party against whom they are to be applied. (*Bruni*, *supra*, 160 Cal.App.4th at pp. 1288-1289, quoting *Aron*, *supra*, 143 Cal.App.4th at p. 808.)

Substantive unconscionability is perhaps best shown here by comparing the arbitration agreement in the Purchase Agreement with the arbitration agreement in the HBW Warranty.

The arbitration agreement in the Purchase Agreement called for neutral arbitration before a retired judge or experienced attorney or mutually agreed-upon other arbitrator. The arbitration was to be governed procedurally and substantively by California law. And the agreement allowed latent and patent construction defects to be litigated in court.

By contrast, the HBW Warranty arbitration agreement extends not just to the builder but to "any other person whom the homeowner contends is responsible for any defect" in or to the

home or the real property upon which it sits, and also applies to the sale of the home by the builder. The arbitrator is chosen solely by the HBW Corporation. California law is supplanted by the FAA. (The FAA has been construed, in the wide context of interstate commerce including residential subdivision home purchases, to preempt the California statute that allows latent and patent construction defects to be litigated in court notwithstanding an arbitration agreement.) (*Shepard v. Edward Mackay Enterprises, Inc., supra,* 148 Cal.App.4th at pp. 1094-1095, 1097, 1101; *Basura v. U.S. Home Corp., supra,* 98 Cal.App.4th at pp. 1207-1208; see Code Civ. Proc., § 1298.7.) And homeowners are foreclosed from joining together to present a claim ("No arbitration proceeding shall involve more than one single-family detached dwelling").

Again, the documents speak for themselves. There is ample evidence to support the trial court's factual finding of substantive unconscionability, and the legal standard of such unconscionability has been met here.

We offer two final thoughts. One, Arnaiz raises several contentions that the FAA governs any arbitration agreement here. However, these contentions put the cart before the horse. Whether a valid arbitration agreement exists must be determined before a determination can be made as to what law applies to the agreement. "[C]alifornia law governs whether an arbitration agreement has been formed in the first instance, and whether an

arbitration agreement exists is an issue for judicial determination." (*Baker*, *supra*, 159 Cal.App.4th at p. 893.)

And, two, in light of our conclusion that the arbitration agreement in the HBW Warranty is unconscionable, we need not address the trial court's further conclusion that Code of Civil Procedure section 1281.2, subdivision (c) also applies here to foreclose arbitration. (Under that statute, arbitration may be foreclosed if "[a] party to the arbitration agreement is also a party to a pending court action . . . with a third party, arising out of the same transaction . . . and there is a possibility of conflicting rulings on a common issue of law or fact.")

DISPOSITION

The order denying Arnaiz's motion to compel arbitration and stay court action is affirmed. Plaintiffs are awarded their costs on appeal. (Cal. Rules of Court, rule 8.278 (a)(1), (2).)

BUTZ, J.

We concur:

NICHOLSON, Acting P. J.

HULL, J.